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Impact of Recent Legislation and Regulation Improvements on Business Opportunities on the Russian Insurance Market

(Individual Report)

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Abstract

Emerging new regulatory practices and legislative changes are among major drivers of business development and competitive advantage in heavy regulated financial services industry.

Analysing recent legislative and regulatory improvements in Russian insurance industry we try to estimate potential opportunities created by these recent changes and to forecast further trends of development of Russian regulatory and legal environment.

Briefly these trends could be summarised as follows:

- Strengthening of the capital requirements;
- Improving liquidity and profitability of insurance reserves;
- Attention to corporate governance in insurance industry;
- Gradual opening of the market to foreign investors and competitors;
- Introduction of multiple new kinds of mandatory liability insurance and combating tax evasion insurance operations.

Subject to successful implementation this measures are supposed to civilize Russian insurance market making it attractive for foreign insurance and reinsurance brokers and underwriters. Monitoring Russian insurance regulation can enable foreign insurance companies to utilise "first move" opportunities as soon as they will arise in this rapidly developing market. Some of them are described below.

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Index of Abbreviations

ARIA - All-Russian Insurance Association

BMS H&D - BMS Harris & Dixon Reinsurance Brokers Ltd.

BRIC - Brazil, Russia, India and China

CIS - Commonwealth of Independent States

FISA - Federal Insurance Supervision Authority of the Ministry of Finance

FSSS - Federal State Statistics Service

IMF - International Monetary Fund

OECD - Organisation for Economic Co-operation and Development

ASN - Agency of insurance news – 'Insurance Today"

Duma - State Duma of Federal Assembly of Russian Federation (Lower Chamber of Russian Parliament)

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Introduction

Rationale of research

Regulation in financial services industry is often regarded as one of the major factors of successful business development or to the opposite business frustration. Indeed it is true for the vibrant Russian insurance industry where most of the latest and current changes originate in recent, existing and expected changes in legislation and regulation practices. The purpose of this report is to identify and describe major legal, legislative and regulatory developments, which had or might have an impact on Russian insurance and reinsurance markets and individual businesses. We will also try to estimate, which business development or business restriction implications they creates for industry players. In particular we will try to analyse impact on the development of the business of the new entrants, such as BMS Harris and Dixon Reinsurance Brokers (BMS H&D).

Report structure

This report consists of introductory part, main – analytical part and conclusions summarising major findings. Main part is separated into the following sections: 1) legal, 2) regulatory and 3) legislative issues.

Proposed structure reflects the intensity of impact on commercial opportunities and business environment in Russian insurance industry by each of the mentioned groups of acts and practices.

Methodology

Approach and CAMEL model

This report aims to identify recent and expected key legal, regulatory and legislative developments and their impact on business development opportunities in Russian insurance and reinsurance industry.

To approach many of these issues systematically we will apply where appropriate a CAMEL model often used both for analysis of individual financial institutions and the whole financial industries.

Used materials and courses of data

In the course of this research we made every effort to use the most up-to-date information. The list and description of used resources is quite similar to the list provided in the Group management project due to contiguous field analysed and supplementary nature of this research. In particular we used the following sources of information.

Official statistics

We accumulated official statistics on Russian insurance companies and particular aspects of their operations to illustrate the impact of recent regulation and new legislation on insurance industry. Relevant data has been gathered from the Federal Insurance Supervision Authority (FISA), All-Russian Insurance Association (ARIA), Federal State Statistics Service (FSSS) and Ministry of Finance.

Interviews

This report also makes use of the information gained during 12 semi-structured interviews we undertook in Moscow and St. Petersburg with top and senior managers of Russian insurance and reinsurance companies, and reinsurance brokers. These interviews provided valuable insights and first-hand practitioners' perspectives on key issues of emerging regulatory and legislative trends. Interviews are sighted on unanimous bases to protect the confidentiality of our interviewees.

Analytical reports

We located a number of analytical reports, in part or fully dedicated to the regulatory and legal issues of Russian insurance market or analysing implications of recent developments. For instance, we examined such reports as Expert RA rating agency's reports "Investment Policy of Insurance Companies: moving towards the market, 2005" and "Russian Insurance Market, I quarter 2006". Although these reports varied in scope and focus, as well as in respect of period considered, they did assist to establish a firm ground for our own analysis and conclusions.

Company data

The companies' data formed an important part of our research agenda. This category comprises both publicly available information, such as company reports, commentaries or market updates, and unpublished information with a certain degree of confidentiality attached to it. We obtained this type of information during the interviews, from different publication sources as well as through email as a result of our direct personal communication with individuals concerned.

Mass media publications

During our work on the project we went through and critically analysed a wide collection of articles in general, financial and industry press, monitored internet sites featuring insurance news and interviews with industry professionals.

Legal documents

Particular emphasis was made on recently adopted legislation and legislation currently considered by the Parliament or discussed at a stage of public and professional debate. Legal acts of executive authorities also reviewed in this paper to form a more clear vision of the changes highlighted in the legislative acts. We also observe changes in regulatory policies which recently lead to a dramatic change in insurance market landscape. Some attention was paid to the commentaries and other legal information relating to Russian insurance industry. For this purpose we used online legal databases, such as Garant, Consultant and Kodeks and other available resources.

Analysis

Legal

Overview

Russian legal system is still in the process of prompt development. At the same time insurance legislation in Russia is relatively detailed and systematic compared to some other areas of law. This enables a rather stable development of the industry and attracts international players, especially in those areas, which till recently have not required any licensing, such as brokerage services.

One of the major legal problems at the moment is an absence of clear rules of portfolio and license transfer in the case of insolvency and mergers and accusations of insurance companies. M&A process in the industry intensifies due to the increasing capital requirements. Still, if there would be clear rules in this respect that could prompt the process and make it less risky for policyholders and counterparties of insurance companies.

Another example of legislative lacuna is absence of clear provisions on e-commerce in Russia. Disregarding the fact that internet-originated turnover grows rapidly there is still no clear legal provisions on electronic signature. Because of this uncertainty practices of contract conclusion and payment vary in different companies and regions. Two major trends due to this uncertainty are as follows: 1) the policies are not delivered electronically and 2) money are usually paid in cash or by postal/bank transfer but seldom in an electronic way.[1]

This brief examples show that there are areas requiring legislative attention, when generally legal system with respect to insurance should be recognised as fairly satisfactory.

System of applicable law

Laws and other legal acts

The basic legal provisions about insurance are included in parts I and II of the Civil Code of Russian Federation of the 26.01.1996 (CCRF). For example, chapter 48 of CCRF regulates contractual peculiarities of insurance relations.

Most of the public aspects (mandatory insurance, licenses, statutory exceptions, capital and reserve requirements etc.) are regulated in special Federal statutes, acts of supervisory authorities and other mandatory norms mentioned or not mentioned in CCRF. A list of the most important of them is given at the bibliography part below.

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[1] "Internet – insurance today." IFin. Retrieved on 25 July 2006, from [http://www.ifin.ru/insurance/ibtoday.stm].

The major trends of Russian legislation are continuous 1) liberalisation of the market, 2) establishing new standards for better corporate governance, assets and risk management, 3) cleaning up insurance market from semi-insurance operations.

These legislative improvements are recently supported by regulatory measures and more strict supervisory policy which we will describe in the next section.

Court Decisions

Although Russia is not a country of precedent law, still previous court decisions of the higher instances have a particular guideline meaning for the lower courts. This means that particular attention should be given to the court practice in the areas which are not fully covered by law, such as M&A of insurance companies and reinsurance.

For example in 1998 due to the absence of legal regulation of derivative's markets the Supreme Court declared all the forward and futures deals as bet deals not enforceable by law. This led to the loss of roughly US $ 30 billion for the participants in this market.[2] Since then no such deals are legally binding until the relative legislation will not be passed.

[2] Penzin K 2001, "About the derivatives market in Russia." Money and credit. №1, 2001. Retrieved on 30 September 2006 form [http://www.mirkin.ru/_docs/articles03-045.pdf]. It is relatively difficult to estimate the exact turnover of the forward market as derivative liabilities were considered as off-balance ones. This gives rise to variable evaluations of the forward market from 10 to 70 $US billion.

Licensing

Variable conditions for obtaining a license by insurance company are described in a table in Appendix 2 below. Briefly the list of requirements includes the following:

- Particular legal form;
- Only certain form of capital contribution;
- Requirements to citizenship, residence, qualification, experience and reputation of the top-management;
- Plans as to containing financial stability and solvency margin;
- Restrictions as to the maximum size of one obligations and assets comprising insurance reserves;
- List of planned particular types of insurance and drafted rules.

To issue a licence Federal Insurance Supervisory Authority of the Ministry of Finance (FISA) requires a draft of insurance standard terms for each type of insurance for study and further approval.

One of the recent positive developments in insurance legislation is an introduction of obligatory licensing for insurance and reinsurance brokers before 1 July 2007. They will also have to report to FISA.

One of the reasons for such a new regulatory measure was practical absence of understanding even between professionals as to the real number and kind of activities of reinsurance brokers operating in

Russian market. As was mentioned in the Group report, at the moment there are about 1,500 insurance and reinsurance brokers included in the State registry of brokers. However, according to different estimations only as many as 200 of them really operate on the market, usually as motor insurance and third party liability (MTPL) intermediaries. Most of them appeared as a result of financial crisis in 1998, when many employees lost their jobs and registered insurance and reinsurance brokers. Some companies have already terminated their operations, but since no respective notification has been rendered, their company names still appear in the State registry. This confuses official statistics and increase the asymmetry of information problem in this segment of the market. Some individual brokers firms, in fact act as insurance agents rather than brokers. This also affects statistics and impacts the reliability of information as to the real insurance brokerage business.

Described legislative measures on one hand make it more difficult for new brokers to enter Russian insurance market, but on the other hand it is expected to make industry more transparent and to furnish market players with valuable information. Expected consolidation of the market may also lead to emergence of new collective bodies, developing the whole industry and protecting collective interests as a result of better transparency.

It should be also expected that the well-established international brokers will not have any problems with getting relevant license. This might impose some additional time constrains, which should be taken into consideration in the case of building up a physical presence in the Russian market.

Regulatory

As mentioned in a broad body of literature regulation is one of the major criterion, which is taken into consideration while designing a business development and marketing strategies for insurance and reinsurance organisations (Beardsley et al (2005), p. 93). It is also important that even greater impact then existing regulation has an anticipated regulatory policy, which often opens new opportunities or on the contrary narrows the field of operation for insurance companies.

CAMEL model

CAMEL model is one of the well-known frameworks designed to analyse the major parameters of functioning of financial organisations. Using this model where it is appropriate we will consequently review all recent regulatory developments concerning capital adequacy – ‘C’, asset quality – ‘A’, management – ‘M’, earnings – ‘E’, and liquidity – ‘L» of Russian insurance companies.

CAMEL model is often used for the quantitative analysis of stability of financial organisations and involves monitoring the ratios briefed in Figure 1 below.

Figure 1: Typical structure of CAMEL analytical model

Components	Ratios
Capital Adequacy	- Capital Adequacy Ratio - Advances to Assets - Government Securities to Total Investments
Asset Quality	- Gross NPAs to Net Advances - Net NPAs to Net Advances - Total Investments to Total Assets - Net NPAs to Total Assets
Management Efficiency	- Total Advances to Total Deposits - Business per Employee - Profit per Employee
Earnings	- Operating Profits to Average Working Funds - Spread to Total Assets - Net Profit to Average Assets - Interest Income to Total Income - Non-Interest Income to Total Income
Liquidity	- Liquid Assets to Total Assets - Government Securities to Total Assets - Liquid Assets to Demand Deposits - Liquid Assets to Total Deposits

Source: Young et al., 1999 and Barr et al., 2002

At the same time as long as our research involves more qualitative analysis of regulatory developments rather then quantitative research on particular organisations and is not backed by substantial statistical data we will use this model in slightly simplified way – by simply grouping the regulatory issues in accordance with this framework.

The major reason for this is that analysis of the named ratios is not required for the purposes of this research. It is also vital that unlike in the banks supervision area in Russian insurance supervision does not publish detailed enough financial data on insurance companies. Sometimes even required consolidated data is not available in public domain.

Accordingly, we will not analyse the ratios, but rather the groups of issues following the CAMEL framework to analyse how Russian regulators address them in their recent work.

Capital adequacy

Capital adequacy is one of the major issues in the Russian financial sector. Russia is a party neither to Basel I and II nor to Solvency I and II capital measurement and capital standards frameworks. This causes considerable hindrance in development of domestic insurance industry, which is dramatically undercapitalised comparing to countries with developed economies. Total insurance industry's capital in August 2006 was RUR 147 billion (US $ 5, 5 billion).[3]

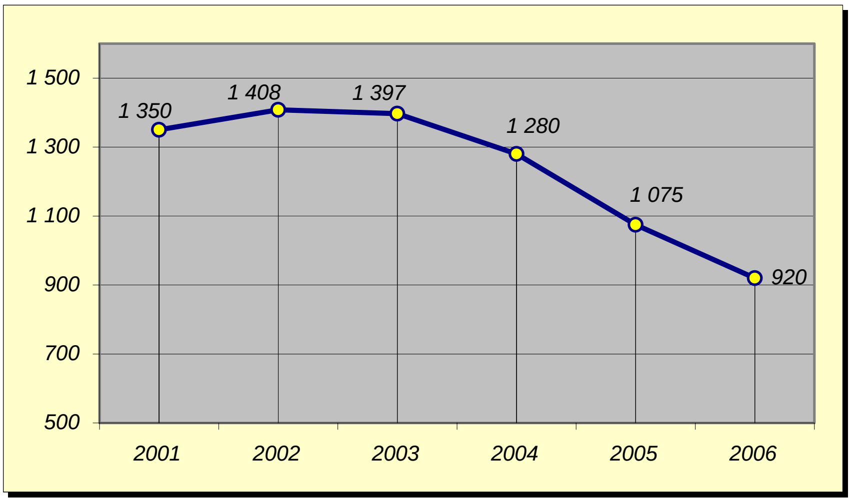
Rise of capitalisation was undertaken in several stages by amendments to the "Insurance Law" and following withdrawal of licences from the companies not complying with new capital requirements in due time. This led only on 2005 to a cumulative increase in chartered capital of Russian insurance companies by 21,3 per cent bringing it in June 2006 up to US $ 5 billion level. On 1 July 2006 FISA simultaneously withdrew 133 licenses from insurance companies as a result of alleged lack of capital. Later on nearly half of the licenses were returned back to the companies. Nevertheless this case reflexes the pace of supervisory

[3] New State Registry: since the last 7 months the number of insurers decreased nearly by 15%, but capitalization grew by 2,9%. 25 August 2006. Retrieved on 25 September 2006, from [http://insnews.ru/index.php?option=com_content&task=view&id=25739&Itemid=110].

authorities in consolidating domestic insurance industry to prepare it to international integration. Recent efforts lead to 2,9 per cent increase in capital and 14,4 per cent (155 companies) decrease in the number of market players just in the first three quarters of 2006 (Figures).[4] These results are more visually illustrated in Figures 2 and 4 below.

Figure 2: Number of insurance companies in existence

as at the end of the year, 2001– 3 quarter 2006



Source: Federal Insurance Supervision Authority; ASN

At the same time many local managers notice that in Russian circumstances even considerable size of chartered capital does not always guarantee the rights of creditors in the same volume. This as possible as the market value of assets contributed to the chartered capital does not always match the face value. For example promissory notes of affiliated companies often have quite low liquidity and thus their value should be discounted at the rate considering time value of

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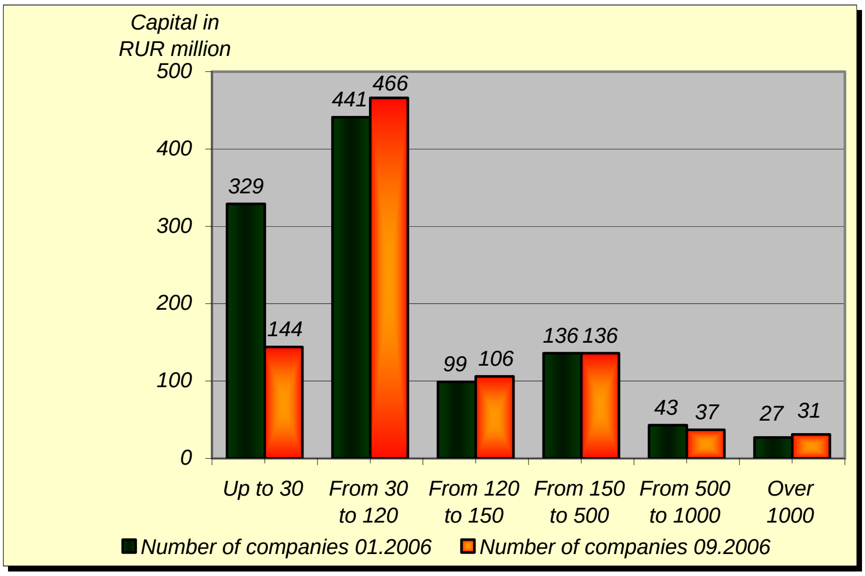
[4] Ibid.

money and risks of the company contributing these securities to the chartered capital.

To improve this situation and to unify the types of assets allowed for capital formation Ministry of Finance on the behalf of FISA adopted in 2005 a new Regulation “About the requirements as to the structure and composition of assets, acceptable for capital purposes of insurer»,[5] which establishes a list of assets acceptable for capital formation. Regulation specifically restricts contributions by bills of exchange of affiliated companies or promissory notes of the companies, which do not have particular rating of international or domestic rating agencies. As was noticed by the first deputy CEO of Rosgosstrakh insurance company Mr. Dmirty Morozov these amendments will lead to the situation when «the issue of fighting the schemes will move from the level of political restriction to the level of economic stimulation» (Expert RA, Russian Insurance Market, I quarter 2006). First signs of market clearance from non-profitable or financially weak insurers already visible. Diagram in the Figure 3 visualises described above trend.

[5] Regulation “About the requirements as to the structure and composition of assets, acceptable for capital purposes of insurer”, approved by the Order of the Ministry of Finance No 149н of 16.12.2005.

Figure3: Change in the number of companies in each capital group during 2006



Sources: ASN, according to the State registry of insurers;

Table in Figure 4 below numerically proves shift of all the surviving companies towards more reliable capital size.

Figure 4: Dynamics of Capitalisation of Russian insurers in first 3 quarters of 2006

Size of the capital, million RUB	**1 January 2006**		**1 August 2006**	
	Number of companies	Their share in insurance industry	Number of companies	Their share in insurance industry
Up to30	329	31 per cent	144	15.65 per cent
From 30 to120	441	40 per cent	466	50.65 per cent
From 120 to150	99	9 per cent	106	11.5 per cent
From 150 to500	136	13 per cent	136	14.8 per cent
From 500 to1000	43	4 per cent	37	4 per cent
Over 1000	27	3 per cent	31	3.4 per cent
Total:	***1075***	***100 per cent***	***920***	***100 per cent***

Sources: ASN, according to the State registry of insurers

Accordingly the number of smallest companies fell dramatically when the number of companies with larger capital has rapidly increased during several recent months. As was noticed above not only current regulation prompts consolidation process but also expectations that the new amendments requiring by 1 July 2007 the chartered capital to be increased for general insurance companies up to the minimum of RUR 30 million (US $ 1,04 million) will dully became effective and enforceable. Life insurance companies should raise a capital of RUR 60 million (US $ 2,08 million) and reinsurers – of RUR 120 million (US $ 4,16 million) in the course of the following several months.

Not only capital requirements make companies to increase their capital it is also organic growth of the most successful market players and expectation of the WTO entry by the weaker companies that encourage companies to strengthen their capitals by appealing to shareholders, public offerings, and other means.

The majority of significant market players understand the benefits of stronger and more transparent industry. For example one of our interviewees noticed:

> *"A fairly strict approach has been adopted by the Federal Insurance Supervision Authority. They have in mind to bring a number of insurance companies down to few hundreds, may be about 200-300. Probably, this is a correct thing to do since it is nearly impossible to exercise an effective control over too many insurers. Moreover, small insurance companies don't provide a real insurance coverage,*

but are involved predominantly in tax evasion schemes. Therefore, this tendency is a good one."

Supervisors are even more radical in their assumptions. They say it might be only several dozens of insurance companies left in quite near future.[6]

Assets quality

Besides permanent pressure towards increase of the capital authorities started paying attention to the quality and structure of insurer's assets. FISA claimed in 2006 to be carefully watching about 57 per cent of insurance companies for the solvency monitoring purposes. According to the Head of FISA Mr. Lomakin-Rumjantsev these 57 per cent of companies raise concerns because of the high loss ratios (over 100 per cent) or because of violation of solvency requirements.[7]

In the end of 2005 the average structure of assets of Russian insurance company according to Expert RA "Investment Policy of Insurance Companies: moving towards the market, 2005" report was as shown below in Figure 5.

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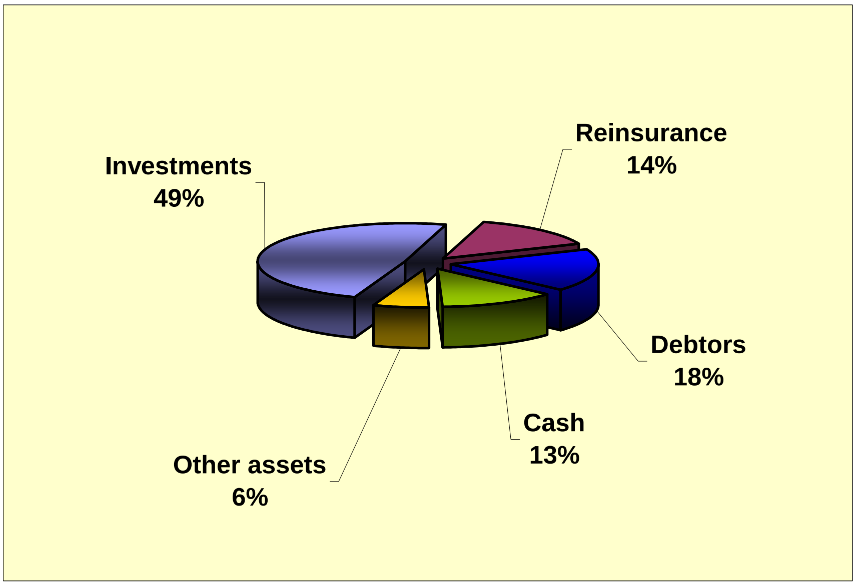
[6] Kadykova M 2006, "FISA Forecast." Gazeta. 3 August 2006. No.136. Retrieved on 25 September 2006, from [http://www.gzt.ru/business/ 2006/08/02/213014.html].

[7] Kadykova M 2006, "FISA's Forecast". Gazeta. 03 August 2006. No.136. Retrieved on 25 September 2006, from [http://www.gzt.ru/business/ 2006/08/02/213014.html].

Figure 5: Average asset's structure of Russian insurer in the end of 2005



Source: Expert RA

Although share of debtors in the assets structure on insurance companies is continuously decreasing, 18 per cent indicated in the above diagram is still quite a high proportion compare to insurance companies from developed markets.

Regulators also mention that in Russian conditions real solvency margin should be 30 per cent higher then the formally prescribed one and about 22 per cent or 196 companies do not currently qualify for this requirement. Russian supervisory watch dog declared that only 2 per cent or about 20 companies are routinely and fully complying with solvency provisions.

The issue of assets portfolio arose after adoption in the end of 2005 of new Rules "On investment of insurance reserves by insurers" (Rules of reserves' investment or Rules).[8] According to them by 30 June 2006 all insurance companies should have brought their reserves in accordance with new requirements and have provided reports in accordance with new standards. This allowed to supervisors for the first time to gather quite detailed and accurate information about investment instruments used by domestic insurance companies and their proportion.

Provisions of the Rules became more sophisticated not only in respect of types of assets allowed for investment and their share in the overall reserves, but also with regard to the quality of these assets evaluated by independent parties, such as independent international and local rating agencies.

At the same time market players notice that there are some uncertainties as to investment requirements, which can also affect the insurance industry's landscape in the long run. As one of such lacunas can be named the absence of clarification if the minimal rating of the investment recipient of BBB- (Baa3) should be interpreted as international or domestic one. Taking into account young age of Russian rating market there is no clear understanding of correlation between ratings of international and domestic rating agencies.[9] Absence of relevant clarifications creates opportunities for evasion of

[8] Rules "On investment of insurance reserves by insurers", approved by the Order of Ministry of finance of 08 August 2005 N 100H.

[9] "Russian insurance market. First half of 2006." Retrieved on 10 September 2006 from [http://www.raexpert.ru/ratings/insurance_rank/I-2006].

recent strict requirements or to the opposite for unexpected sanctions for insurance companies using legal uncertainties for their own benefit.

Some professionals, such as Mrs. Ekaterina Kurkovskaya form Ingosstrakh consider new Rules of reserves' investment to be quite rigid and limiting ability of insurance companies to reach an expected rate of return. She considers it to be especially disadvantaging for the life insurance companies, which might be not able to compete with alternative investment opportunities, such as mutual and private pension funds (Expert RA, Russian Insurance Market, I quarter 2006). Some other experts are worried about the lack of investment instruments recommended by supervisor or their low liquidity (Expert RA, Russian Insurance Market, I quarter 2006).

With all respect to the criticism of the new Rules, which will fully enter into force on 1 January 2007, we suppose they should be seen as a positive move towards market transparency and stability and as a definite step in direction to Solvency I compliance.

FISA already announced that it is going to pay particular attention to the profitability of portfolio as recently it noticed a tendency that low investment profits often evidence use of very poor investment instruments, such as bills of exchange of affiliated companies or other stake holders. Besides low returns on these assets there are some concerns as to their liquidity what will be addressed in the liquidity section below.

Management

On 17 January 2004 a new edition of Insurance Law entered into force establishing some additional criteria for the top-management of insurance companies. This was seen as a very positive development towards increasing security and well being of the market although rose quite a number of concerns in the industry.

Firstly, §§ 1 and 2 of the Article 32.1 "Qualification and other requirements" requires that the newly appointed CEOs and chief accountants should hold a degree in economical or financial studies and have experience of work in the relevant field of at least two years.

This amendment was broadly criticized by professionals, who pointed out that many current top insurance executives have natural science and other types of not financial college education. Their concerns were supported by the current head of FISA Lomakin-Rumyanzev and the relevant law softening the requirements just for any high education was even passed through both chambers of the Parliament.[10] These amendments were criticised by the law department of the president's administration and the bill remained not signed leaving requirements of proper financial qualifications in force.

Letter of the Ministry of finance N 24-00/КП-44 of 4 March 2004 goes in some more technicalities and clarifies the new Rules requirements in

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[10] Kuznetzov A 2005, "Hunting for directors". Russian policy. 1 April 2005. Retrieved on 10 September 2006 from [http://www.ancor.ru/labour_market/article/articleid/549].

terms of what means high education and relevant experience and by what kind of documents they should be evidenced.

Secondly, § 5 requires both directors and chief accountants to be resident in Russia. Paragraph 6 of the part 1 of the Article 32.3 prohibits appointment of individuals having not expired or not redeemed criminal convictions. Expiration of a criminal conviction takes place in one to eight years after the end of punishment depending on how serious was the crime (Art. 86 of the Criminal Code).

Although at the moment in Russian insurance companies there is no established practice of adopting codes of corporate practice or other industry corporate governance standards improvements described above should be considered as very helpful for the young Russian insurance market.

Finally, a number of recent new amendments to the Article 71 of the Federal Law “On joint stock companies” made top-management, members of supervisory board and board of directors accountable for the damage to the joint stock company. Up to this moment there is only one published civil case decision making liable ex-CEO of one of the JSC companies for the damage he incurred. Still mentioned provisions should be considered as having effect on the behaviour of the management of joint stock insurance companies. Article 44 of the Law “On the limited liability companies” contains similar provisions allowing testing top-management decisions in the court in case of damage to stake holders of LLC companies.

Practical increased accountability of the management in the recent years implicitly follows from the growing demand for the D&O insurance in Russia.

Hence, we should conclude that although at the moment supervisors still pay more attention to financial aspects of companies' stability, there are some positive developments in accountability of the management as well. These efforts could be expected to increase once the stage of primary clearing of the market from completely unreliable and hardly solvent companies will be finished.

Earnings

In the Earnings' part of CAMEL framework the capability of insurance companies for a relatively stable and continuous profitability is usually analyzed. One of the reasons why earnings become a subject of separate research is strong believe that ability to reach stable earnings ratios reflects both sound risk and asset management and corporate governance policy if the company. Earnings ratio analysis could be seen as a bridge between technical (financial) and 'soft' (managerial) aspects of insurance company's performance.

Earnings component usually involves collection and systemization of historical data and monitoring company's earnings on a routine regular basis.

FISA recently announced that it is going to pay special attention to profitability of insurance companies' portfolios. It claims that more then 50 per cent of them have frequently loss ratios shooting over 100 per cent.[11]

More strict regulation as to the types of assets in insurers' reserves should smoothen financial performance of the companies in the long run and restrict heavy investment both in very risky or gainless instruments. Besides reducing liquidity and credit risks this should make earnings ratios more realistic and stable. This should also influence the management quality as most of the companies will be in similar situation on the investment side of their business.

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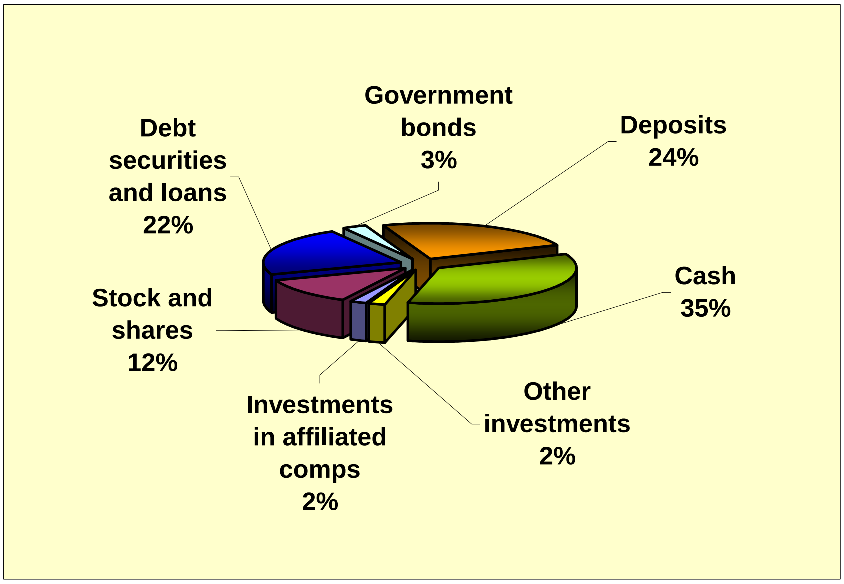
[11] Kadykova M 2006, "FISA Forecast." Gazeta. 3 August 2006. No.136. Retrieved on 25 September 2006, from [http://www.gzt.ru/business/ 2006/08/02/213014.html].

Liquidity

In 2005 structure of the investment part of reserves of an average insurance company according to Expert RA was as follows.

Figure 6: Share of particular assets in overall investments in 2005



Source: Expert RA

Illustrated allocation of investments besides low profitability (deposits, cash) according to the supervisors was not liquid enough as well (debt securities, investments in affiliated companies and loans).

To improve this situation supervisors have recently introduced mentioned earlier Rules of reserves' investment for insurance companies. According to Lomakin-Rumyanzev adoption of these Rules allowed to increase the company's assets liquidity ratio within first 9 month of 2006 by 37 per cent.[12] According to Vladimir Skvortsov, the CEO of Alfa-Strakhovanie insurance company, in Russian conditions "behind the words "low liquidity and profitability assets" usually stands the promissory notes, which many market players use to boost their reserves and capital".[13] The easiest way to identify such assets in company's portfolio without analysing accounting and financial reports according to Skvortsov is to have a look at profitability ratios of insurance reserves.

To conclude this overview of recent regulatory trends we should notice that in several major areas such as capital, assets and corporate governance management Russia has been having considerable regulatory developments since several recent years. Results of many of them just started becoming apparent as there was too little time since they were implemented. Others showed to be more effective even in a short term prospective and are evidenced by impressive numerical results: liquidity ratio grew by 37 per cent and industry capital – at the rate of 2,9 per cent semi-annually. In any case recent regulatory improvements show to be creating more comfortable environment for foreign market entrants, such as BMS H&D.

A new requirement of mandatory licensing of insurance and reinsurance brokers also should not create considerable barriers for reputable

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[12] Kadykova M 2006, "FISA Forecast." Gazeta. 3 August 2006. No.136. Retrieved on 25 September 2006, from [http://www.gzt.ru/business/ 2006/08/02/213014.html].

[13] Ibid.

foreign brokers although it can create problems for smaller brokers involved in semi-insurance schemes.

Hence, recent more active regulatory position of Russian authorities should be seen as an “important driver of innovation” and business development in terminology of Taylor et al (2005)[14] rather then creating constrains for insurance industry. It creates new and improves existing business opportunities by improvement of the whole market infrastructure and changing the perception of insurance industry both from clients’ and professionals’ points of view.

Minimisation of tax evasion and money laundering schemes

Most independent experts including the rating agency Expert RA are recognising a strong trend towards shrinking of semi-Insurance activities on the market. The reasons for this are continuous and ever toughening combat of risk-free operations by FISA and now even tax and police authorities.[15] Still, differences in volumes of real insurance and minimisation schemes were considerable even recently (Compare volumes in table below).

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[14] Taylor et al 2005, p 349.

[15] “Russian insurance market. First half of 2006.” Retrieved on 10 September 2006 from [http://www.raexpert.ru/ratings/insurance_rank/I-2006].

Figure 7: The nominal and estimated real size of Russian insurance market, 2005

Class of business	Premiums written (nominal figures, US$)	Share of tax evasion (% of nominal premiums)	Premiums written (real figures, US$)
Property	6.45	37%	4.06
Liability	0.56	38%	0.35
Personal lines	2.22	28%	1.60
Life	0.88	78%	0.19
Compulsory lines	6.93	–	6.93
Total	17.04	22.95%	13.13

Source: Federal Insurance Supervision Authority, Expert RA rating agency

Massive amounts of taxes were minimised in 1990s through flourishing tax-minimisation insurance schemes. Usually they were used to avoid taxation on staff's salaries and the leaders of this grey market were among the insurance industry leaders in amount of collected premiums. In the new century supervisors started withdrawing licences from these companies but these were Sisyphean toil measures as management of liquidated company would just establish a new company and reach the same level of operations during a very short period of time.

During the last year situation changed considerably as insurance supervision started cooperation with tax authorities and police. First explicit notice to the grey insurance market was given in February 2006 when the head of the Nizhniy Novgorod insurance company "Nasha Nadezhda", Vitaly Buichev was sentenced for 5 years of imprisonment as a result of provision of tax evasion solutions to the local business. Still some small companies and their clients were ready to take risks until the top-management of the "Car plant "Ural" were not accused of tax evasion in August 2006. Court decision in this case is still expected but even the very fact of police investigation against the management of a client company most probably will reduce incentives for using insurance as a mean of tax minimisation.[16] According to the article 199 of the Criminal Code management involved in tax evasion can be sentenced for up to 6 years term.

These recent harsh but fair measures led to considerable decline both in life and property tax evasion insurance schemes. According to Expert RA life insurance premiums declined in the first half of 2006 by RUR 24,4 billion ($ US 878 million), and insurance payments – by RUR 33,7 billion (US $ 1,21 billion).

[16] "A salary insurance scheme was disclosed." 31 August 2006. Retrieved on 10 September 2006 from [http://www.bankir.ru/news/newsline/31 August 2006/60391]

Legislative

Legislative initiatives are carefully monitored by business in many countries and Russia is not an exception in this respect. Moreover, many legislative developments, such as introduction of MTPL insurance were initiated by a well-organised Russian insurance professional society itself. Successful implementation of MTPL insurance since 2003 gave confidence to the industry and it repeatedly initiates further legislative debates some of which will be reviewed here.

Introduction of Mandatory Insurance of Dangerous Objects

According to the Exerts from the Legislative agenda of the State Duma of the Russian Federation (Lower Chamber of the Parliament) in October it is going to have a second reading of the bill on Mandatory insurance of liability of the operators of hazardous facilities.17 Adoption of this law would create a new considerable segment of liability insurance.

The major reason why this sector might be interesting for the reinsurance brokers is the nature of the risks which are going to be covered by this type of insurance and the amount of premium.

[17] "Exerts from the Legislative agenda of the State Duma of the Russian Federation in the area of insurance during the autumn session of 2006." Retrieved on 25 July 2006 from the site of Russian Insurance Association [http://ins-union.ru/U_FILE/MS_DOC/plan_zakonodatelnoy_dejat_vyderzhki.doc]

At the same time the bill has a number of opponents. For example G. Sergienko – the president of the Fuel Union of Russia noticed that in modern edition bill is a pure financial burden for the owners of the gas stations and not a kind of insurance. He mentioned that the average premium per station is estimated to be $ US4000 and the limit of liability for this type of objects is about $ US2 million. At the same time the overall damage on all the gas stations of Russia has not exceeded $ US100.000 in 2005.[18] Oleg Tishkin – CEO of Kapital Strahovanije supported this position that the bill should not be a mechanism of subsidising insurers but rather should be reconsidered.[19]

New Mandatory Insurance of State Officials

In October Duma is also going to consider amendments to the Civil Code, which enable later introduction of mandatory insurance of the state officials. Taking in account that the number of officials reached in the end of 2005 according to the Federal State Statistics Service 1,462 million people it could be also quite a market in the nearest future.[20]

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[18] "Law on insurance of hazardous objects has advocates and opponents." 22 February 2006. Retrieved on 10 September 2006 from [http://www.allinsurance.ru/biser.nsf/AllDocs/EFIA-6M9B95-22-02-06?OpenDocument].

[19] Ibid.

[20] "Notice about the number of state officials in the government bodies and municipalities in 2005." Retrieved on 25 July 2006 from [http://www.gks.ru/kadr/text.htm].

Mandatory insurance of appraisers

On14 July 2006 Constitution of the Russian Federation approved amendments to the law “About appraiser’s activities”, which require mandatory insurance of their liability of at least $ US12000.[21]

Debate as to introduction of mandatory terrorist coverage

Some experts mention that according to a number of researches Russia is on the third place after Iraq and India in the rating of most dangerous places in the world from the terrorism risk prospective.[22] This permanent threat of terrorist attacks in the major cities of Russia leads to increase in the number of insurance companies demanding terrorism coverage.[23] Creation of a Russian Anti-Terrorist Insurance Pool was one of the measures considered to help in development of this kind of insurance.

Another actively discussed measure is an introduction of mandatory insurance for the mass entertainment events. Several bills were already rejected by the parliament but there are still several proposals waiting in a pipeline They usually propose mandatory terrorism cover for any commercial public place with capacity of more then 200 people at a

[21] “Appraisals will be obliged to insure their professional liability.” 14 July 2006. Retrieved on 17 July 2006 from [http://www.allinsurance.ru/biser.nsf/AllDocs/EFIA-6RPGMT-14-07-06?OpenDocument].

[22] Ibid.

[23] Gulchenko A 2006, “Wind of change.” 23 March 2006. Retrieved on 25 July 2006, from [http://www.insur-info.ru/interviews/285].

time.[24] Main arguments against this kind of insurance are those that the government will shift its public responsibility to the private sector.[25] The debate is still not over and in case of adoption of relevant provisions the amount of premiums will be avalanching and could easily reach US$ 10 million per annum according to some of our interviewees.

Ratification of Vienna Civil Liability Convention of 1997

On 22 March 2005 Russia ratified Vienna Convention “On civil liability for nuclear damage of 1997”. This new obligation imposed by the parliament on the nuclear industry according to Professor A. Jordish will double or even triple premiums paid in the following years.[26] At the same time, Prof. Jordish points out that even these increased amounts would be quire minor for most of the nuclear industry players. For example for Rosenergoatom (managing company for all the nuclear power stations of Russia) it will constitute 0.18% of turnover, for Siberian Chemical Plant – 0.07%, mining plant – 0.35% and for scientific centres – 0.4%, respectively. It is also mentioned that annual premium for subsidised 5 scientific reactors would be in the range of US$ 300-400 thousand. According to the financial reports of RNIP analyzed by

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[24] See also: “List of the legislative bills introduced by the members of the committee of the security in 2005.” Retrieved on 25 July 2006, from [http://www.duma.gov.ru/csecure/otch/4/p1.doc].

[25] Rusakova G 2005, “Policy against terror.” Private money. 03 May 2005. Retrieved on 25 July 2006, from [www.personalmoney.ru/txt.asp?id=377070&rbr=].

[26] Jordish A 2005, “International regime of civil liability for nuclear damage.” Nuclear Strategy. No 17. 2005. Retrieved on 30 June 2006, from [http://www.proatom.ru/modules.php?name=News&file=article&sid=70].

Prof. Jordish own retention of the pool under some contracts will be reaching US$ 130 million in 2005-2006.[27]

Taking into account that in Russia at the moment there are 24 nuclear energy reactors and there are plans to build another 40 till 2025 increase in premiums caused by participation in Vienna Convention creates considerable business opportunities including foreign reinsurance brokers and members of specialised pools, such as Lloyds Syndicate 1173.

As was illustrated in this section legislative initiatives in Russia are quite variable. Some of them already found their approval by the Parliament and President. Others are still in the stage of public and parliamentary debate. In any case it is quite important that most of them aim to develop Russian insurance market by introduction of new types of obligatory insurance. Once a company will prepare for such a development in advance it can gain some competitive advantage by utilising a "first move" benefits in these business lines.

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[27] Jordish A 2005, «International regime of civil liability for nuclear damage.» Nuclear Strategy. No 17. 2005. Retrieved on 30 June 2006, from [http://www.proatom.ru/modules.php?name=News&file=article&sid=70].

Insurance fraud

Most of our interviewees noticed the avalanche-like rise of insurance fraud in Russia. Especially it concerns the third party transport liability insurance. According to the General Insurance Alliance the share of fraud in third party transport liability insurance reaches 30 per cent of all compensations paid to the clients.[28]

Recent amendments to the Rules of reserves' investment by insurance companies unified a set of investment instruments available to insurance companies. They excluded extreme speculative types of assets from companies' portfolios what will put a pressure on the companies to monitor their claim handling practices in a better way to avoid payments on fraudulent claims.

Some interviewees stated that the work in development of joint industry databases has already started. Insurance society also hopes to build up cooperation with road police to get more information on accidents and to avoid double payment or even intentional fraud.

As long as the market is getting more and more competitive and the loss margins continue to grow most of the market players will have to join information pooling systems to combat fraudulent use of promptly developing insurance market.

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[28] "Generally Insurance Alliance joined the TOP-20 of MTPL insurers." Facts and Statistics. 7 August 2006. Retrieved on 10 September 2006 from [http://www.allinsurance.ru/biser.nsf/AllDocs/INFO-6SFE9E-07-08-06?OpenDocument].

Conclusion

This brief overview of recent developments in Russian insurance legislation and regulatory practices justifies the conclusion that regulation and legislation improvements remain one of the major drivers of raid insurance industry expansion and transformation.

Constant monitoring of these developments is crucial for such a heavily regulated businesses as insurance. Indeed it is true in Russia where companies often create a separate positions and even divisions for the purposes of screening and identifying possible regulatory changes and designing a sound response to rapidly changing legal environment.

Legislative and regulatory developments in Russia have particular importance as the whole law system of this country is relatively young and experiences accelerated transformation aiming to follow economic boom, which Russia experiences now. Thus the business practices, which were acceptable several years ago, now with the help of financial market authorities move into shade, allowing the real insurance business to take the stage.

It is well known that at least in private sector legislation follows the economic needs of entrepreneurs. Well organised Russian professional bodies increasingly demand clear rules from legislators and regulators and support them in creating sound framework for fair competition and transparent business operation. Accordingly, participation in the major industry meetings and associations could be highly recommended for obtaining most up-to-date information about regulatory and legislative developments.

Finally, anticipated further legal and regulatory improvements illustrated above will create in the nearest future a variety of opportunities in the Russian market for quite mature international businesses, such as BMS H&D. Recent market entrance by such companies as Aviva, Česká Pojišt'ovna, ACE Group, Colemont Insurance Brokers and RFIB Group proves this statement better than any abstract conclusion. Mr. Surinder Beerh, a Chief Executive Officer of Colemont's global operations, says that "Our new operations in Moscow and Samara will undoubtedly prove to be cornerstones of our ongoing expansion around the world" and the role of recent regulatory and legal development for making such a decision should be assumed considerable.

Appendices

Appendix 1

Comparative requirements for Russian Insurers and Russian Insurers with foreign investments

	Russian Insurer with foreign investments[29]		Russian Insurer
	1. Associated (daughter) Russian Insurer[30]	**2. Russian Insurer with 49%-100% of foreign capital**[31]	**3. Russian Insurer with less than 49% of foreign capital**
I. Legal form	Russian enterprise established for Insurance Activities (stated in charter) in the legal form of limited liability company or joint stock company[32]	Russian enterprise established for Insurance Activities (stated in charter) in the legal form of limited liability company or joint stock company	Russian enterprise established for Insurance Activities (stated in charter)
II. Total presence of such entities in the Russian insurance market should not exceed **(Art. 6.3 Insurance Law)**	25% of the market	25% of the market	No restrictions
III. Restrictions on activities (Art. 6.3 Insurance Law)	Can not insure: -life -obligatory types of insurable accidents -obligatory state insurance -insuring sales and contracts for the state needs	Can not insure: -life -obligatory types of insurable accidents -obligatory state insurance -insuring sales and contracts for the state needs	No restrictions

[29]This division of Russian enterprises with foreign investments and simply Russian enterprise is given in the article 6 of the Insurance Act. Also in the § 1 abs 2 of the Regulation on issuing the permissions to the insurance entities with foreign investments. There are some special requirements to the associated enterprises which had license before 23.11.1999 – the moment when the restricting amendments came into force.

[30] Daughter enterprise is that according to the Art. 105 RCC, decisions of which can be made by the main enterprise by means of the capital share, contract or other means, more regulations on daughter enterprises are contained in the Art. 6 of the Joint-stock company Act and in the Art. 6 of the Limited liability company Act.

[31] It is very possible, that the entity with more than 49% of foreign capital would be also an associated (daughter) enterprise at the same time. Then provisions of both columns are applied.

[32] § 5 of the Resolution of the Supreme Soviet of Russia 27.11.1992 N 4016-I, Art. 6 of the Insurance Act, §4 Regulation of 16.05.2000 N 50н.

IV. Measures of state control			
1. Investing into the capital stock: **a. Permission of FISA**	Required: Permission granted if the 25% quota of the market share will not be exceed	Required: Permission granted if the 25% quota of the market share will not be exceed *(No restrictions if were established before 23.11.1999)* [33]	Required: Permission granted if the 25% quota of the market share will not be exceed *(If the foreign share by investing will not reach 49% - than permission is granted in any case)*
b. Permission of the Antimonopoly authorities (Art. 16 Finical services competition Act)	Required if: - acquisition of 20% shares, stocks of Insurer or 10% of book value assets and the stock capital of the Insurer is more than 10.000.000. RUR = 333.000 EUR[34]	Same	same
c. Notification of the Federal securities commission (Art. 29 Securities Act)	The Buyer is responsible for notification, but the Seller can also notify	same	same
2. Establishing subsidiaries and daughter enterprises in Russia (6.4 Insurance Law)			
a. Permission of FISA	Prohibited investments if the foreign capital will exceed 25% share of the market	Same	Same

[33] Art. 3 of the Federal Act of 20.11.1999 Nr. 204.

[34] Government Decree of 07.03.2000 N 194

b. Form of investment	Monetary	Monetary	Monetary
c. Citizenship of the Director and Chief Accountant of the Insurer and their residency	Russian	Russian	Russian
d. Requirements to the foreign shareholder (6.4 Insurance Law)	15 years of foreign experience + 2 years of participation in activities of Russian Insurers	15 years of foreign experience + 2 years of participation in activities of Russian Insurers [35]	No restrictions
V. Financial stability measures			
1. Minimal capital	Depending on the type of insurance/reinsurance	Depending on the type of insurance/reinsurance	Depending on the type of insurance/reinsurance
2. Maximum size of one obligation	Depending on the type of insurance/reinsurance	Depending on the type of insurance/reinsurance	Depending on the type of insurance/reinsurance
3. Reserves36	Depending on the type of insurance/reinsurance	Depending on the type of insurance/reinsurance	Depending on the type of insurance/reinsurance
4. Assets allowed in insurance reserves	Depending on the type of insurance/reinsurance	Depending on the type of insurance/reinsurance	Depending on the type of insurance/reinsurance
5. Normative proportion of the assets and obligations = margin of solvency (M.)[37]	**Margin of solvency -** is the scale in which the Insurer should have own capital free of all claims except the claims of the founders, reduced by the sum for the value of immaterial assets and accounts receivable with expired terms of	**Normative margin of solvency (M) is equivalent to the largest of the following two figures (A or B) multiplied on the correction factor (F).** M norm= A (or B)*F	F=(P-R)+(C1-R)+(C2-R)/ P+C1+C2 P – Payments to Insurants R – share of Reinsures in P, C1 and C2 C1 – Change of the reserve of claimed by not yet paid damages

[35] § 2 and § 11 abs. B of the Regulation on issuing the permissions to the insurance entities with foreign investments.

[36] Regulated in Standards of investing of the insurance reserves.

[37] Regulation about the methods of actives' and obligations' proportion calculation 2.11.2001 N 90н

	payments.		
	M=P+A+R+E-L-D-O-I-B	A = 0,16*(P*Y-(R+Pa+O))	C2 – Change of the reserve of happened, but not yet claimed damages
	P – Paid up capital A – Added capital R – Reserve capital E - retained Earnings of current and previous years L – not covered Losses D – Debts of the founders in payments into joint stock O – Own stocks redeemed from the shareholders I - Intangible assets B – Bill receivable the terms of cancellation of which are already expired	P – gathered premium Y – period of one year R – returned premiums Pa - preventive actions reserve O – Other mandatory payments form the premiums required by law B=0,23/3*(3Y*(P-R+C1+C2) 3Y – period of 3 Years P – Payments to the Insurants R – received Revisable after subrogation C1 – Change of the reserve of claimed by not yet paid damages C2 – Change of the reserve of happened, but not yet claimed damages	

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